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Article 9 (associated enterprises): updated of its commentary and transfer pricing issues

Update of the commentary on article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries

Note by the Secretariat

Summary

The present note provides a brief background on the update of the commentary on article 9 (Associated enterprises) of the United Nations Model Double Taxation Convention between Developed and Developing Countries. The issue will be discussed at the tenth session of the Committee of Experts on International Cooperation in Tax Matters. The annex to the note contains, for consideration by the Committee, amendments to the commentary proposed by the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing, in accordance with its mandate.

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Background

1. In accordance with Economic and Social Council resolution 2004/69, the mandate of the Committee of Experts on International Cooperation in Tax Matters is to keep under review and update as necessary the United Nations Model Double Taxation Convention between Developed and Developing Countries to give special attention to developing countries and countries with economies in transition in dealing with that and other aspects of its mandate.

2. During the previous update of the United Nations Model Convention in 2011, the main issue for the commentary on article 9 related to the wording in paragraph 3, which expressed a recommendation by the former Group of Experts that countries should follow the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter "OECD Transfer Pricing Guidelines"). Following discussions, it was agreed to retain the reference, which endorsed the arm's length principle in determining the transfer pricing issues implicit in article 9 and which recognized the role that the OECD Transfer Pricing Guidelines played in practice in applying the arm's length principle. While most members of the Committee considered that those views were still appropriate, some members raised concerns about the appropriateness of the views of the former Group of Experts, as set out in paragraph 3 and questioned whether they were too broadly stated. In particular, they indicated that the recommendation for countries to follow the OECD Transfer Pricing Guidelines might need to mention that the Guidelines were only for guidance in applying the "arm's length principle. It was agreed to consider those issues further after the finalization of the United Nations Practical Manual on Transfer Pricing for Developing Countries (hereinafter "United Nations Transfer Pricing Manual"), without prejudging the outcome of such consideration. In the meantime, paragraph 3 of the commentary was amended to clarify that the views expressed by the former Group of Experts in the 2001 United Nations Model Convention had not been fully considered by the Committee, although there was universal agreement that the arm's length principle was the foundation of article 9 of the United Nations Model Convention.

3. The Committee has now produced the United Nations Transfer Pricing Manual, which provides guidance on the practical aspects of transfer pricing, focusing on the issues commonly faced by developing countries.

4. At a meeting of the Core Group of the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing, the commentary on article 9 of the United Nations Model Convention was considered, and a draft text (see annex) proposed. The draft recognizes the value of the OECD Transfer Pricing Guidelines while noting that they are not the only source of guidance. The United Nations Transfer Pricing Manual is also explicitly mentioned as providing authoritative assistance in the field of transfer pricing.

5. The Committee is invited to consider the changes, which attempt to recognize and balance the various perspectives on the above-mentioned issues. If the Committee approves the revised text, or expresses agreement with any of the amendments, the revised commentary will be incorporated into the next version of the United Nations Model Convention, which is expected to be completed within the four-year term of the current members of the Committee.

Annex

Proposed amendments to the commentary on article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries

Article 9

Associated enterprises

A. General considerations

1. Article 9 of the United Nations Model Convention reproduces Article 9 of the OECD Model Convention, except for paragraph 3. ~~As noted in paragraph 1 of the OECD Commentary, "[t]his Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms".~~ **Both Models embody the same arm's length principle that forms the basis for allocating profits resulting from transactions between associated enterprises. It Article 9** should be considered in conjunction with Article 25 on mutual agreement procedure and Article 26 on exchange of information.

2. The application of the arm's length ~~**rule to**~~ **principle for** the allocation of profits between the associated enterprises presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's length principle.

~~**3. With regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms, the former Group of Experts stated that the Contracting States will follow the OECD principles, which are set out in the OECD Transfer Pricing Guidelines. The former Group of Experts, in the United Nations Model Convention revised in 1999, came to the view that these conclusions represent internationally agreed principles and it recommended that the Guidelines should be followed for the application of the arm's length principle which underlies the Article.**~~

~~**The views expressed by the former Group of Experts have not yet been considered fully by the Committee of Experts, as indicated in the Records of its annual sessions.**~~

3. **It is noted that the Commentary of the OECD Model Convention includes the following general statement on the Article:**

> **1. This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms. The Committee[1] has spent considerable time and effort (and continues to do**

[1] **The OECD Committee on Fiscal Affairs.**

so) examining the conditions for the application of this Article, its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm's length terms. Its conclusions are set out in the report entitled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, which is periodically updated to reflect the progress of the work of the Committee in this area.

4. The OECD Commentary continues by stating that ~~Committee considers that~~ the ~~OECD~~ *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* "represen[t]s internationally agreed principles and provid[e]s guidelines for the application of the arm's length principle of which th[e]~~is~~ Article is the authoritative statement." The Committee considers that those guidelines contain valuable guidance relevant for the application of the arm's length principle under Article 9 of bilateral tax conventions following the two Models. The Committee also considers it to be highly important for avoiding international double taxation of corporate profits that a common understanding prevails on how the arm's length principle should be applied, and that the two Model Conventions provide a common framework for preventing and resolving transfer pricing disputes where they would occur. With that aim in mind the Committee has developed the United Nations Practical Manual on Transfer Pricing for Developing Countries which pays special attention to the experience of developing countries, reflects the realities for such countries, at their relevant stages of capacity development, and seeks broad consistency with the guidance provided by the OECD Transfer Pricing Guidelines.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

4 5. Paragraph 1 provides that in cases involving associated enterprises, the tax authorities of **a** Contracting States may for the purpose of calculating tax liabilities rewrite the accounts of the enterprises if as a result of the special relationship between the enterprises the accounts do not show the true taxable profits arising in ~~that~~ **those** States. It is evidently appropriate that an adjustment should be sanctioned in such circumstances~~**, and this paragraph calls for little comment**~~. The provision applies only if special conditions have been made or imposed between the two enterprises. Clearly no re-writing of the accounts with a consequential adjustment should be made if the transactions between the associated enterprises have taken place on a normal open market commercial basis, in other words, at arm's length.

5 6. In the OECD Committee on Fiscal Affairs' Report on "Thin Capitalisation",[2] it is stated that there is an interplay between tax treaties and domestic rules on thin capitalisation which is relevant to the scope of the Article. As noted in paragraph 3 of the OECD Commentary on Article 9:

a) The Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower

[2] Adopted by the Council of the OECD on 26 November 1986 and reproduced in volume II of the full-length version of the OECD Model Tax Convention at page R(4)-1.

to an amount corresponding to the profits which would have accrued in an arm's length situation;

b) The Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;

c) The application of rules designed to deal with thin capitalization should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.

The OECD Commentary continues:

4. The question arises as to whether special procedural rules which some countries have adopted for dealing with transactions between related parties are consistent with the Convention. For instance, it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes found in domestic laws are consistent with the arm's length principle. A number of countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level. Also, almost all member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with such situations by means of corresponding adjustments (see below) and under mutual agreement procedures.

Paragraph 2

67. In the words of the OECD Commentary, "The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B." The OECD Commentary observes that "[p]aragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation".[3]

However, according to the OECD Commentary,

6. [...] an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph may not be invoked and should not be applied where the profits of one associated enterprise are increased to a level which

[3] Paragraph 5 of the OECD Commentary on Article 9.

exceeds what they would have been if they had been correctly computed on an arm's length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount.

7. The paragraph does not specify the method by which an adjustment is to be made. OECD member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of Article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A.

8. It is not the purpose of the paragraph to deal with what might be called "secondary adjustments". Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in paragraph 1 and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y) and that in those circumstances there could have been other tax consequences (*e.g.* the operation of a withholding tax) depending upon the type of income concerned and the provisions of the Article dealing with such income.

9. These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case [...]. [N]othing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

10. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended — in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as

a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment [...].

11. If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented; the Commentary on that Article contains a number of considerations applicable to adjustments of the profits of associated enterprises carried out on the basis of the present Article (following, in particular, adjustment of transfer prices) and to the corresponding adjustments which must then be made in pursuance of paragraph 2 thereof [...].

~~7~~ **8.** The view has been expressed that a correlative adjustment under paragraph 2 could be very costly to a developing country which may consider not including paragraph 2 in its treaties. However, paragraph 2 is an essential aspect of Article 9 and failure to provide a correlative adjustment will result in double taxation, which is contrary to the purpose of the Convention. A country should closely examine the primary adjustment under paragraph 1 before deciding what correlative adjustment is appropriate to reflect the primary adjustment. Some countries take the view that it may be desirable to eliminate the obligation that a State may have to make a correlative adjustment when the other Contracting State has previously adjusted the transfer prices. This approach can be achieved by changing the word "shall" to "may". Contracting States may, during bilateral negotiations, use the word that is convenient. However, there is no consensus on this point and the language of paragraph 2 remains unchanged.

Paragraph 3

8 9. The United Nations Model Convention was amended in 1999 by the insertion of paragraph 3. Paragraph 2 of Article 9 requires a country to make an "appropriate adjustment" (a correlative adjustment) to reflect a change in the transfer price made by a country under Article 9, paragraph 1. ~~**The new**~~ **Paragraph 3** provides that the provisions of paragraph 2 shall not apply where the judicial, administrative or other legal proceedings have resulted in a final ruling that, by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default. In other words, in case a final order has been passed in a judicial, administrative or other legal proceeding pointing out that in relation to the adjustment of profits under paragraph 1 one of the enterprises is subject to a penalty for fraud, gross negligence or wilful default, there would be no obligation to make the correlative adjustment under paragraph 2. This approach means that a taxpayer may be subject to non-tax and tax penalties. Some countries may consider such double penalties as too harsh, but it should be borne in mind that cases involving the levy of such penalties are likely to be exceptional and there would be no application of this provision in a routine manner.